No. 12,386

IN THE

United States Court of Appeals

For the Ninth Circuit

Twin Oaks Company,
Petitioner,

vs.

Commissioner of Internal Revenue,
Respondent.

Reply Brief for Petitioner

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TABLE OF AUTHORITIES CITED

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Reply Brief for Petitioner

The Commissioner's brief (herein cited "Com. Br.") makes no attempt to deal with the analysis of the case set out in petitioner's main brief (herein cited "Br.") and, so far as appears, was written without regard to the development of our argument.

Accordingly, we now limit ourselves to comment upon certain of the arguments advanced in the Commissioner's brief. Point I, below, is concerned with the fundamental question of whether the earnings of the partnership can be taxed to petitioner corporation, and Point II with the procedural question under the Tax Court's Rule 50.

I.

The validity of the partnership under State law. Counsel for the Commissioner repeatedly refer to the "alleged" or "purported" partnership (Com. Br. pp. (I), 2, 11, 12, 18, 19). This is an unfair and misleading characterization of the partnership here involved. The evidence is crystal clear that under State law a legally recognized partnership existed, with the assumption of unlimited personal liability by the partners and all other incidents of the partnership relation; and that the business after January 1, 1941 was conducted by this partnership (Br. pp. 10-17). Of course, the Tax Court made no finding to the contrary.

"State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." *Morgan v. Commissioner,* 309 U.S. 78, 80; *Heiner v. Mellon,* 304 U.S. 271, 279. The Commissioner argues that the present partnership is a "fiction", "a mere formal arrangement for siphoning profits from the taxpayer" (Com. Br. pp. 16, 18). But the obvious starting point for an inquiry into such charges is the governing business law. See *Commissioner v. Culbertson,* 337 U.S. 733, 744-745. And where, as here, no mere transitory or anticipatory arrangement is involved—that is, where there is no fraud or sham, but a distinct commercial entity comes into existence and conducts the business in question throughout the years—a reference to the State law both begins and ends the inquiry. See *E. R. Goold v. Commissioner,* decided by this Court May 4, 1950, and cases cited from this and other Courts (Br. pp. 27-33).

The argument that the business conducted by petitioner prior to 1941 and thereafter by the partnership was "unitary in character". Counsel attempt to erect as a major

proposition the argument that the business here in question was "unitary in character" (Com. Br. pp. 11, 13-15).[1] The argument assumes the existence of a rule of law that a business labeled "unitary" must invariably be operated in a manner to yield the maximum taxes, and, taxwise, can never be transferred or subdivided. The minor premise is that the lumber and building supply business here involved is such a "unitary" business and was impermissibly transferred or subdivided.

First, there is no such rule of law. The only pertinent rule of law is that which distinguishes between a transaction which is genuine and one which is a mere fraud or sham. An obvious case where there was no genuine division of a business is *R. O. H. Hill, Inc.*, 9 T. C. 153 (Br. p. 41). On the other hand, if two or more entities genuinely conduct their affairs separately, then it is immaterial whether the separate businesses were formerly conducted as a unified whole.[2]

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1. It may be noted that the single judge of the Tax Court placed no such emphasis upon the unitary-in-character argument, relegating it simply to an attempted means of distinguishing the instant case from various other cases decided by the Tax Court in favor of the taxpayer (R. 282).

2. The Commissioner's brief usefully cites (p. 12, fn. 1) Cooper, "Section 45," 4 Tax L. Rev. 131 (1949), but there should be no implication that this article supports the Commissioner's position, for on the contrary it confirms our own position with respect to business "split-ups" and other aspects of the case. At pages 144-149 the author reviews the cases cited in our main brief (pp. 38-43). The author's ultimate conclusion (p. 167) is that:

> "The Commissioner *may not* merge, consolidate or shift into one taxpayer the income of another business which is in fact separately conducted, even though the businesses constitute related functions of an overall enterprise and might have been, or at one time were, conducted as a single business. He may do so only if analysis reveals that one or more of the allegedly separate businesses were not in fact separate or had no real substance."

Second, the instant case is not an example of the splitting up of a "unitary" business. Prior to January 1941 petitioner operated a lumber and building supply business. On January 1, 1941, the partnership took over the operation of this business. No question of a split-up arises. It is true that petitioner continued to own the real estate and thereafter leased it to the partnership. However, the renting of real estate was obviously not the business previously engaged in by petitioner; and nothing is more common in the commercial field than for a going business, like the partnership, to lease the premises which it occupies. In fact, the record discloses that the partnership's neighbor in Eugene, the Long-Bell Lumber Company, likewise leases the real estate on which it does business (R. 55).

In *Ames Theatre Co.*, 5 T.C.M. 44, a corporation, which owned theatre buildings and operated them prior to the taxable year in issue, leased the buildings to a partnership formed by its stockholders. In *Fair Price Stations, Inc.*, 5 T.C.M. 401 (Br. p. 49, fn. 22) a corporation leased its gasoline stations to a partnership formed by its stockholders. In each case the Commissioner attempted to tax the partnership's income to the corporation, and in each the Tax Court held for the corporation, recognizing the separate existence of the partnership.[3] We have heretofore cited numerous cases, holding for the taxpayer corporation, where the businesses involved were entangled to an extent wholly lacking in the present case (Br. pp. 37-40, 49, fn. 22).[4]

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3. After referring to these cases Cooper concludes, 4 Tax L. Rev. 131, 149: "* * * the operation of property may be separable from its ownership."

4. In addition to certain of the cases previously cited and discussed in our main brief (pp. 38-42, 49, fn. 22) the Commis-

The Commissioner's reliance on non-existent findings of fact. Counsel attempt to buttress the decision below with the argument that certain dealings between petitioner and the partnership were not at arm's length. In support of this, their brief points to the fact that the partnership's note, given to petitioner in part payment of certain of its assets, drew interest at 2%, and cites the testimony that the prevailing interest rate for *commercial* loans was 6%. It is also contended that the rental established in the lease of petitioner's real estate to the partnership was inadequate because it was fixed at $3000 a year whereas the fair rental value was "about $7000" a year (Com. Br. pp. 15-16).

With respect to the interest rate, counsel ignore the undisputed testimony of the vice president of the First National Bank of Eugene that "contracts of this nature are usually at a lower rate than the going bank interest rates" and that "I don't know of any" standard rate for such a contract (R. 186-187; Br. pp. 14-15, fn. 5). The Tax Court made no finding or comment concerning the interest rate; any finding that the interest rate was inadequate would have been clearly erroneous.

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sioner cites only *Advance Machinery Exchange, Inc.*, 8 T.C.M. 84 (Com. Br. p. 15). The brief makes no attempt to assimilate the facts of that case to the present case. On every significant point the facts there were wholly different. In the *Advance* case there were in form four separate entities, but all were

> "* * * engaged in the same business, at the same location, using the same equipment, with the same employees, and to a large extent supplying the same customers. All four businesses were controlled by J. Blachman and Seymour Blachman, father and son. The two operated the business and kept the books and records of all four businesses in such a way that the net profit of each could be manipulated as they saw fit, and, in general, so conducted the business that it is impossible to determine where the activities of one or the other begin and end." 8 T.C.M. 84, 89.

As to the rental rate, there is some dispute but the preponderance of the testimony supports the $3,000 annual rate fixed in the lease. Here, also, the Tax Court made no finding or comment to the effect that the rental rate was inadequate, or otherwise on this subject (Br. pp. 14-15, fn. 5). Any finding that the rental was inadequate, if made, would have been essentially an attempt to substitute the judgment of the Tax Court in 1949 for that of the parties to the transaction in 1941. For another reason, moreover, even an adverse finding on this point would not be sufficient to support the decision below. The undisputed fact is that a lease was made, and that a substantial rental was paid. The adequacy of the rental as such is not in issue. The Commissioner's position is much broader—namely, that the alleged inadequacy of the rental set in the lease, together with numerous other elements, establish that the partnership and its operation were a fraud or sham. But the other elements in the case prove exactly the contrary and establish that the partnership genuinely existed and produced the income in question.[5]

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5. The recent case of *E. R. Goold v. Commissioner,* decided by this Court May 4, 1950, confirms the foregoing analysis. The Court pointed out in that case that "the tax incidents of the transfer itself" were not in issue.

Also pertinent is the following extract from the *E. R. Goold* opinion.

> "Under existing law, the father had complete freedom, at least up to the date of this writing, to transfer his property in any way he saw fit. So far as the disputed income tax deficiencies are concerned, whether or not the sale was an improvident transaction, is not of the business of the tax collector. The tax collector's apparent opinion that the father should not have sold valuable property to his son without a cash consideration, or that he should not have taken in payment a note payable out of future profits, is utterly immaterial."

The point, in any event, is that the evidence on this subject, viewed most favorably from the standpoint of the Commissioner, is at best disputed, *and that the Tax Court made no findings whatsoever on the point.* Therefore, the elementary rule is applicable that, on review of Tax Court decisions, the Court of Appeals may not make its own findings of fact but must reverse if the Tax Court findings are inadequate to support its decision.[6]

The Commissioner's treatment of other evidence. Equally untenable is the Commissioner's treatment of the fact that the partnership endorsed one or more of the petitioner's renewal notes representing loans made to petitioner by the First National Bank of Eugene prior to the transfer of the business to the partnership (Com. Br. p. 16; cf. Br. pp. 16-17, fn. 7). There is no significance whatsoever in this fact. The loan was made to petitioner, not the partnership, and the proceeds had gone solely to petitioner. The loan having been made when petitioner operated the lumber and building supply business, it was quite natural that upon a renewal note given after the transfer of the business, the Bank should seek to obtain the partnership as an endorser. As the vice president of the Bank testified, with commendable candor, "* * * I think we always try to get all the signatures we can" (R. 183).

From the foregoing, the Commissioner also argues that the Bank and the public generally regarded the partnership and petitioner as a single business entity (Com. Br. p. 16).

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6. "* * * we have no power to make findings and can but reverse if the findings are inadequate." *Commissioner v. Kolb*, 100 F.2d 920, 925 (9th Cir.). To the same effect are: *Commissioner v. Stinchfield's Estate*, 161 F.2d 555, 556 (9th Cir.); *Hormel v. Helvering*, 312 U.S. 552, 560; *Helvering v. Rankin*, 295 U.S. 123, 131. And see *Securities Comm'n v. Chenery Corp.*, 318 U.S. 80, 88.

But the record contains nothing in support of this argument and in fact is all to the contrary. There is express testimony that the Bank, in January 1941, was promptly informed that the partnership had taken over the lumber and building supply business (R. 189, 190). There is no evidence whatsoever that any supplier or purchaser or anyone else who dealt with the partnership believed, or had reason to believe, that he was dealing with petitioner, or with the partnership and petitioner, rather than with the partnership alone. In January 1941, the partnership filed an assumed business name certificate with the County Clerk of Lane County, Oregon, and published notice to this effect (R. 36-37, 135-136, Pet. Exh. 19; Br. p. 16).

Business purpose and tax motive: "substance versus form." Our main brief has dealt at length with the question of business purpose, tax motive and substance versus form (Br. pp. 25-28, 28-33, 33-36, 44-49). The Commissioner's treatment of this subject does not attempt to meet our analysis, but, like the opinion of the single judge below, mingles together and confuses two separate fields of inquiry (Com. Br. pp. 16-18).

(1) *The transfer of the business from petitioner to the partnership.* Upon a careful reading, it will be seen that neither the opinion below nor the Commissioner's brief maintains that the transfer of the business *from* the petitioner *to* the partnership was dominated by a motive to avoid corporate taxes. Yet it is corporate taxes (not personal income taxes) which alone are involved in this proceeding.

As we have pointed out, the single judge below made no finding as to tax motive, though mentioning in his opinion

"reallocation of income among family groups" (Br. p. 11, fn. 3). The judge, in his opinion, referred to Scharpf's desire for a larger participation in the profits and for a form of organization which would permit him to get out more readily. He then spoke of Scharpf's expectation that Rogers (who owned 50% of the corporate stock) should have a half interest in the partnership, and of Roger's decision that his wife also should become a partner (R. 283). It will be seen that these comments, insofar as they have any bearing on taxes, do not single out as significant the discontinuance of the business in corporate form (i.e., corporate taxes) but, rather, the ownership of the business as reflected in the *composition* of the partnership (i.e., personal income taxes).

The Commissioner's brief approaches the matter in back-handed fashion by arguing that there was no "business purpose" for the transfer of the business to the partnership (Com. Br. pp. 17-19), but the record is explicitly to the contrary (Br. pp. 10-11, fn. 3, 45-47). Scharpf wanted a partnership for reasons which had nothing to do with taxes and a partnership in fact came into existence and operated the business.[7]

Like the "unitary" business argument (*supra,* pp. 2-4), business purpose and tax motive are significant only as they throw light on the fundamental question whether the entity involved can be disregarded as a sham or fraud. A familiar mode of stating this test is that the tax laws "look to substance rather than to form" (Br. pp. 25-31

7. Without interrupting the continuity of the argument at this point, we summarize, *infra*, pp. 12-13, the evidence bearing on tax motive.

and cases there cited). Where the thing done is transitory in nature and for this or other reasons appears *equivocal,* then purpose, motive, "unitary" nature of the business, may throw revealing light on the true nature of the transaction. "* * * in interpreting an equivocal transaction motives may be considered as bearing on the real nature thereof." *Brunton v. Commissioner,* 42 F.2d 81, 82 (9th Cir.), certiorari denied, *sub nom., Brunton v. Burnet,* 282 U.S. 889. But where the thing done has substance and hence is not a sham or fraud, as where a new entity in fact comes into existence and operates a business throughout the years, then a tax saving motive and the other considerations here mentioned become immaterial. A method "avowedly chosen in order to reduce taxes" must be respected by the tax collector if it is "real" and not a "sham." *United States v. Cumberland Public Service Company,* 338 U.S. 451, 453, 455.[8]

The reasons summarized in the preceding paragraph justify our repeated insistence that in this case the elements of tax motive and purpose, even had they existed, would be deprived of all significance (Br. pp. 28-33, 44-47). For here there was nothing equivocal; petitioner in fact transferred the business to another entity; the partnership in fact came into existence and has operated the business through the years since 1940. The partners contributed

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8. In addition to the cases cited in our main brief, reference may also be made to the following statement of the law in *John Wachtel Corp.,* 4 T.C.M. 768, 771:

> "We know of no law which prevents stockholders of a corporation from changing the operation of a business by a corporation to operation by a partnership. That is frequently done; and if the purpose is to avoid burdensome corporate taxes, it is not, by reason of that fact alone, invalid."

their individual capital, a partnership agreement was signed, and all requirements of applicable partnership law were faithfully satisfied. Consideration was paid in full for the assets transferred to the partnership by petitioner. The partnership hired its own employees, some 30, and conducted its own business in its own name and on its own credit. Rogers and Scharpf continued to head the business, but not as corporate officers; they and the other partners now exposed themselves to personal liability and all the other incidents of the partnership relation (Br. pp. 12-16).

(2) *The inclusion of the two wives as members of the partnership.* On any conceivable view, a partnership came into existence, of which at least Messrs. Rogers and Scharpf were members. As we have previously pointed out, the single judge of the Tax Court appears to have decided the case on the erroneous theory that the case is governed by the same principles that would apply to the issue whether the two wives could also be regarded as members of the partnership. It was in this connection that the single judge spoke of "a reallocation of income among family groups" (R. 283).

Under *Commissioner v. Culbertson,* 337 U.S. 733, it seems clear that the two wives must be regarded as *bona fide* partners. We again point out, however, that this is not the question at issue in the present case. It is sufficient here that *a* partnership was created, of whomever composed, and that the business was in fact transferred to and operated by such partnership. If this was accomplished, then petitioner cannot be taxed on the income of the partnership. Whether the income reported by the wives can be attributed and taxed to the husbands is a wholly separate question, outside the scope of the present case.

The Commissioner's brief falls into the same error as did the opinion of the single judge, but adds nothing by way of discussion and clarification.[9]

Although not essential, it will perhaps be useful in concluding this discussion to summarize the significant facts bearing upon the inquiry as to tax purpose. Viewing the record as a whole, it is quite understandable that the single judge should have been unwilling to make a finding of a tax avoidance motive as to any aspect of the transfer of the business or of the formation of the partnership (Br. pp. 10-11, fns. 2, 3, 28-36, 44-49).

Scharpf wanted to do business in partnership form for reasons having nothing to do with taxes. At the time of his proposal, taxes could have been no significant problem, for the business was scarcely profitable and the war-time excess profits tax had not even been enacted. As the result of the transfer of the business to the partnership, Scharpf increased his interest as a proprietor from less than 5% to 25%. He and Rogers headed the business and, if anything, the partnership arrangement more accurately reflected Scharpf's contribution to the enterprise than did the corporate form of doing business. Also, it *increased* Scharpf's personal income taxes.

Rogers at first opposed the partnership, and for strictly business reasons; he did not like the unlimited personal

9. In addition to the cases cited in our main brief at p. 37 there should be added *John L. Denning & Co. v. Commissioner*, 180 F.2d 288 (10th Cir.), decided February 8, 1950, reversing the decision of the Tax Court and holding that the income of the partnership there involved could not be taxed to the petitioner corporation.

liability of a partner. He finally consented, on condition that petitioner corporation should continue to hold the real estate. Ironically, it is only the continued existence of the petitioner corporation which makes possible the present controversy. Yet, it was Rogers, opposing the transfer—not Scharpf, favoring it—who wanted petitioner continued. Further, the only new proprietor of the business was Mrs. Rogers. Apart from the fact that as of 1941 her interest could easily have turned out to be worth less than she paid for it, it is significant here also that it was not her husband, but Scharpf, who pressed for the formation of the partnership.

It is clear, therefore, that an underlying purpose of tax avoidance simply cannot be extracted from this record.

II.

The single judge below entered his findings of fact and opinion, directing that decision should be entered under the Tax Court's Rule 50. In computing the deficiencies for the years 1943 and 1944 resulting from his previous determination, the single judge proceeded to deny to petitioner the credits against the partnership income to which it would have been entitled if such earnings belonged to it (Br. pp. 51-55). The Commissioner's brief does not attempt to defend the denial of these credits under Sections 710-720, Internal Revenue Code. It insists, nevertheless, that petitioner had waived a correct computation of its taxes (Com. Br. pp. 19-20).

We do not question the power of the Tax Court to prescribe its own rules of practice and procedure, under Section 1111, Internal Revenue Code. The question, rather,

is whether anything in the terms of Rule 50, or in previous decisions thereunder, fairly put petitioner on notice that it should have taken any action other than what it took to preserve its right to a fair and just computation of its taxes. It is not open to the Tax Court under the procedural due process guaranteed by the Fifth Amendment, nor within its statutory rule-making authority, so to interpret its Rules as to deny to a taxpayer a fair hearing on issues governing the amount of a claimed tax deficiency.

We have previously shown that neither the terms of Rule 50 nor previous interpretations justify the result reached in the present case (Br. pp. 56-61). The cases cited by the Commissioner (Com Br. pp. 19-20) do not meet the facts in the instant case, for they involve new issues asserted by the Commissioner, by the taxpayer or by both, or by the Tax Court itself, *falling outside a correct computation of the tax under the findings of fact and opinion of the Tax Court.* For example, *Fifth Street Bldg. v. Commissioner,* 77 F.2d 605 (9th Cir.), upon which the Commissioner principally relies, involved a question as to computation of invested capital for the year 1921 and a second question as to depreciation for the year 1926. From the report of the case, it appears that after the Board (now the Tax Court) had entered its findings of fact and opinion as to these two questions, and when the case came on for decision under Rule 50, the Commissioner for the first time moved to disallow depreciation for the year 1921; and the taxpayer then moved to exclude certain rentals for that period. Since these were new issues, not relating to a correct computation under the Board's prior determination,

the Board properly denied *both* motions. It was these rulings that this Court sustained (77 F.2d at pp. 608-609).

In connection with our brief discussion of the scope of review in Tax Court cases (Br. III, pp. 61-62), we call to the attention of the Court the recent decision of the Court of Appeals for the Second Circuit in *Orvis v. Higgins,* 180 F.2d 537, which supports our discussion of the test to be applied by the reviewing court.

Respectfully submitted,

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June 15, 1950.